
OLR Bill Analysis

HB 5392

AN ACT PROVIDING CONSUMER PROTECTION TO CLIENTS OF EXCHANGE FACILITATORS FOR TAX DEFERRED EXCHANGES.

SUMMARY:

Under federal law, a taxpayer can transfer certain property held for productive use in a trade or business or for investment (the “relinquished property”) and subsequently receive “replacement property” of a like kind. If the taxpayer uses the replacement property for the same purpose as the relinquished property, the Internal Revenue Service (IRS) does not recognize a loss or a taxable gain from the transaction. This bill imposes requirements on people or businesses who act as exchange facilitators in these transactions.

The bill requires exchange facilitators to:

1. notify clients of any change in the facilitator’s control;
2. maintain a set minimum fidelity bond, or, with certain stipulations, deposit all exchange funds in a separately identified account, a qualified escrow account, or a qualified trust;
3. maintain a specific amount of insurance coverage, deposit an unspecified amount of cash or securities, or provide a specified minimum amount in irrevocable letters of credit; and
4. follow certain rules for handling and investing funds.

The bill also prohibits exchange facilitators from, among other things, making intentionally misleading material representations about any transaction and engaging in fraudulent or dishonest dealings. It subjects a facilitator who violates any of the prohibitions to a possible

civil suit.

The bill allows the banking commissioner to adopt implementing regulations.

EFFECTIVE DATE: October 1, 2013

§ 1 — EXCHANGE FACILITATORS

The bill defines an “exchange facilitator” as a person or entity who:

1. maintains a Connecticut office to solicit business facilitating the exchange of like-kind property or
2. for a fee (a) facilitates an exchange of like-kind property by entering into an agreement with a client in which the facilitator acquires contractual rights to sell the client’s relinquished Connecticut property and transfer a replacement property to the client, acting as an intermediary that qualifies under federal law, (b) enters into an agreement with a client to take title to a Connecticut property acting as an exchange accommodation titleholder that qualifies under federal law, or (c) enters into an agreement with a client to act as a qualified trustee or qualified escrow holder (see BACKGROUND).

An exchange facilitator does not include:

1. a financial institution acting solely as a (a) depository for exchange funds, (b) qualified escrow holder, or (c) qualified trustee, and not otherwise facilitating exchanges;
2. a person or entity (a) teaching seminars or classes or giving presentations to attorneys, accountants, or other professionals about tax-deferred exchanges or how to act as exchange facilitators or (b) advertising the seminars, classes, or presentations; or
3. an entity that an exchange facilitator or person representing one wholly owns and uses to facilitate exchanges or take title to Connecticut property as an exchange accommodation

titleholder.

Under the bill, a “financial institution” is any state or federally chartered bank, credit union, savings and loan holding company, savings and loan association, savings bank, trust company, or trust bank whose accounts are insured by the full faith and credit of the United States, Federal Deposit Insurance Corporation, National Credit Union Share Insurance Fund, or other similar program.

§ 2 — NOTICE OF CHANGE IN CONTROL

The bill generally requires an exchange facilitator to notify each existing client whose relinquished property is located in Connecticut or whose replacement property held under a qualified exchange accommodation agreement (see BACKGROUND) is in Connecticut of any change in control of the facilitator. This applies to any transfer or transfers within a 12-month period of more than 50% of the exchange facilitator’s assets or ownership interests, directly or indirectly.

The clients must be notified within 10 business days of the change in control by fax, email, or first class mail.

The facilitator must also post a notice of change of control on his or her web site for at least 90 days after the change. The notice must state the name, address, and other contact information of the person who received control.

The notification requirement does not apply to publicly traded companies that remain publicly traded after a change in control.

§§ 3-6 — FINANCIAL REQUIREMENTS AND HANDLING FUNDS

Financial, Holding, and Investment Requirements

The bill requires an exchange facilitator to, at all times:

1. maintain a minimum \$1 million fidelity bond executed by an insurer authorized to do business in Connecticut;
2. (a) deposit all exchange funds (funds the exchange facilitator receives from, or on behalf of, the client to facilitate an exchange

of like-kind property) in a separately identified account, and (b) provide that any withdrawals from that account require both the facilitator's and client's written authorizations by commercially reasonable means, including the client's delivery of authorization to the facilitator and the facilitator's delivery to the depository institution of its sole authorization, or delivery to the depository institution of both the client's and the facilitator's authorization; or

3. deposit all exchange funds in a qualified escrow account or qualified trust (See BACKGROUND) with a financial institution and require both the facilitator's and the taxpayer's written authorizations for any withdrawals.

The bill also requires an exchange facilitator to, at all times, maintain a minimum \$250,000 errors and omissions insurance policy executed by a Connecticut authorized insurer, deposit an unspecified amount of cash or securities, or provide at least \$250,000 in irrevocable letters of credit.

Additionally, an exchange facilitator must:

1. hold all of the client's exchange funds, other than the facilitator's compensation, in a way that provides liquidity and preserves principal;
2. notify the client how the exchange funds will be invested or deposited; and
3. deposit or invest exchange funds in investments that satisfy liquidity and preservation of principal investment goals and meet the prudent investor standard.

Under Connecticut law, trustees must follow certain standards when investing and managing trust assets when the trust provisions are not explicit. Among the things, trustees must invest and manage assets as "prudent investors" would and use any special skills or expertise they have. This requirement is referred to as the "prudent

investor standard. ”

Under the bill, the facilitator violates the prudent investor standard if he or she:

1. knowingly commingles exchange funds with the exchange facilitator’s operating accounts or
2. loans or transfers exchange funds to any person or entity affiliated with or related to the exchange facilitator. But, the funds may be transferred pursuant to the exchange contract (a) to pay an exchange expense or complete the acquisition of the replacement property, (b) to deposit exchange funds with a financial institution, or (c) to an exchange accommodation titleholder, a trustee of a qualified trust, or a qualified escrow agent.

The bill allows exchange funds to be pooled. The “pool” is to (1) aggregate multiple clients’ exchange funds for investment purposes to achieve common investment goals and efficiencies and (2) ensure that the exchange funds are readily identifiable to each client for whom they are held, through an accounting or subaccounting system.

Under the bill, exchange funds are not subject to execution or attachment on any claim against the exchange facilitator.

§§ 6-8 — PROHIBITED CONDUCT

The bill prohibits an exchange facilitator from knowingly keeping, or causing to be kept, any money in any financial institution under a client’s name unless the money actually belongs to the client and the client entrusted it to the facilitator.

It also prohibits exchange facilitators or a facilitator’s owners, officers, directors, and employees, from knowingly:

1. making any intentionally misleading material representations about any exchange facilitator transaction;
2. pursuing a continued or flagrant course of misrepresentation or

- making false statements through advertising or by other means;
3. failing, within a reasonable time, to account for any money or property belonging to another person that the exchange facilitator may possess or control;
 4. engaging in fraudulent or dishonest dealings;
 5. committing any crime related to the exchange facilitation business involving fraud, misrepresentation, deceit, embezzlement, misappropriation of funds, robbery, or theft, except there is no violation if the crime was committed by an officer, director, or employee, and (1) that individual's employment or appointment has been terminated and (2) no clients were harmed or those that were harmed received full restitution;
 6. materially failing to fulfill the facilitator's contractual duties to the client to deliver property or funds to the client, unless the failure is due to circumstances beyond the facilitator's control; and
 7. materially violating any of the bill's provisions or the regulations adopted pursuant to them.
 8. The bill permits any person claiming to suffer damage due to the exchange facilitator's illegal actions to file a claim with the banking commissioner against the exchange facilitator to recover damages from such bonds, funds, or policies, or letters of credit set forth above.

The bill subjects any person who violates it to a possible civil suit and requires the person who commences the suit to notify the Department of Banking upon filing it.

BACKGROUND

Exchange Accommodation Titleholder and Qualified Exchange Accommodation Arrangement

Federal law allows an exchange accommodation titleholder (EAT),

through a qualified exchange accommodation arrangement (QEAA) with a property's taxpayer, to act as the beneficial owner of a property for income tax purposes in order to facilitate a like-kind exchange. In order to do so, the EAT must (1) not be the taxpayer for the property or a disqualified person; (2) be subject to federal income tax; and (3) hold the legal title to the property, or other indicia of ownership such as a contract for deed (IRS Rev. Proc. 2000-37).

Qualified Intermediary

Federal law defines a qualified intermediary as a person involved in a taxpayer's transfer of relinquished property who (1) is not the taxpayer or a disqualified person and (2) enters into a QEAA, acquires the relinquished property from the taxpayer and transfers it, then acquires the replacement property and transfers it to the taxpayer (26 C.F.R. § 1.1031(k)-1(g)(4)).

Qualified Trust

According to federal law, a trustee and a taxpayer create a qualified trust through an agreement that expressly limits the taxpayer's rights to receive, pledge, borrow, or otherwise obtain the benefits of the cash or cash equivalent held by the trustee (26 C.F.R. § 1.1031(k)-1(g)(3)).

Qualified Escrow

An escrow holder and a taxpayer create a qualified escrow account through an agreement that expressly limits the taxpayer's rights to receive, pledge, borrow, or otherwise obtain the benefits of the cash or cash equivalent held in the escrow account (26 C.F.R. § 1.1031(k)-1(g)(3)).

COMMITTEE ACTION

Banks Committee

Joint Favorable

Yea 17 Nay 0 (03/14/2013)